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"There is no means of avoiding the final collapse of a boom brought about by inflationary credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe."

Human Action, Ludwig von Mises, p.372
Contemporary Books Inc., Chicago

HIGHLIGHTS

Is the world experiencing a financial mania or is it being starved of liquidity? Contrary to the many confusing answers, we think both answers are true.

Measured by broad money, most industrial countries — particularly the U.S. — are experiencing the lowest liquidity growth of the whole postwar period. To have this coincide alongside extremely bullish financial markets is unprecedented. We explain why this is happening.

We have consistently maintained that the U.S. money muddle — booming narrow money and stagnant broad money — is a clear symptom of a very hazardous situation. All the available money is flooding into the financial markets at the expense of the real economy.

By imposing abnormally low short-term interest rates, the Fed has unleashed a headlong flight into stocks and bonds and through its overabundant reserve injections has propelled and accommodated a speculative boom.

This is the most crucial question for investors: What will be the final outcome of the current runaway monetary policy and its resulting speculative bubble? We review the history books.

Asset price bubbles inevitably end in one and the same way — a bust. Invariably, when that happens, it destroys all of the liquidity trapped in the bubble and in turn depresses the economy.

Just what defines a bubble? All other speculative bubbles have been fuelled by the same thing — monetary inflation fuelled by excessive reserve injections and artificially low interest rates. By that standard, today's situation in U.S. financial markets is marked as a true speculative bubble.

Brokers are counselling that stock markets are not expensive today despite the fact that price-earnings ratios are exorbitant virtually everywhere, maintaining that markets are a bargain relative to short-term interest rates. This couldn't be a more fallacious argument.

Bubble avoidance is the top priority. Accordingly, long-term capital conservation and liquidity should be the key objective of investors. The best way to achieve that is to steer clear of the bubble economies and stock markets around the globe. We continue to recommend short-term money securities and hard-currency bonds — German, Dutch, Swiss and Austrian.

WHAT MAKES A BUBBLE?

Reading the garbled views and comments of financial economists, policymakers, academics and the like, it's plainly obvious: a totally numbing confusion has set in. Try as they might, no one is able to find some past period in history that might fit and shed some light on present economic and monetary affairs. Given a virtual vacuum of theory and understanding of causal relationships, there is confusion and complacency among policymakers and confusion and fear among investors.

In the U.S., confusion is most evident in the contradictory brick-brats being hurled at the Federal Reserve. One group of critics point to the protracted sluggishness of broad money and the economy and accuse it of having done too little, too late, and of having caused the recession. Another group, referring to the runaway growth of the monetary base, bank reserves, and narrow money (M1), takes the Fed to task for an inflationary and excessive easing. Which accusation is closer to the truth?

Clearly having trouble interpreting and unravelling this unprecedented monetary conundrum — soaring narrow money (M1) and stagnant broad money (M2, M3) — the Fed has struck a median course by bowing to both schools of criticism. On the one hand, it down-played and ignored the flagrant sluggishness of M2 and finally discarded it as a monetary target. On the other hand, it wastes little time furnishing any reserves that may be required to accommodate ballooning demand deposits and the huge bank purchases of bonds.

Already for more than a year it's clear that the Fed has had one single monetary target — a Fed funds rate of 3%. In order to keep it there, it has been flooding the banks with excess reserves. It's the exact reverse of the policy strategy of the former Federal Reserve Chairman, Paul Volcker. He targeted bank reserves and instead let interest rates go wherever they might. We want to explain in this letter why today's monetary policy is recklessly expansive and why it is virtually certain that some time in the future it will boomerang into a destructive blow to investors.

BUBBLE ECONOMY VERSUS BUBBLE-HEADED THEORY

As readers know, we have been at direct loggerheads with the complacent consensus view about present monetary trends. We have consistently maintained that this apparent money muddle, far from being a mystery, is a clear symptom of a very hazardous situation. What it reflects is a split between two markets. In sum, what's happening is that all available money is flooding into the financial markets at the expense of the real economy. In other words, while Wall Street inflates, Main Street deflates.

In this vein, we titled our August letter The U.S. Bubble Economy. It seems that some U.S. experts are also beginning to think in the same direction. David W. Mullins, Fed vice-chairman, and Lawrence D. Lindsay, a Fed governor, warned that U.S. interest rates wouldn't be cut any further because of the risk that it might set off a replay of Japan's speculative "bubble" of the late 1980s and subsequently threaten a long-running slump.

Just a few days earlier, the self-appointed monetarist Shadow Open Market Committee, led by Professor Allan Meltzer of Carnegie Mellon University, had expressed virtually the same warnings that the Fed's irresponsible expansionary policy was creating a Japanese-style "*asset price bubble*".

Although the two warnings sounded very similar, they diverged on one most important point. The Fed officials, after mulling the current levels of stock and bond prices, reassuringly concluded that securities were not yet inflated and were reasonably in line with falling inflation and slower economic growth.

While these remarks poured cold water upon the budding hopes for a new cut in interest rates, they also spoke against a rate increase.

Opposing the comforting murmurings of the Fed officials, the monetarist Shadow Open Market Committee lambasted the Fed, accusing it of an irresponsible expansionary policy. Long-bond yields have fallen steeply, Professor Meltzer claimed, because the rampant growth of bank reserves far exceeded loan demand and was prompting banks to use their excess cash to buy government securities.

On the surface at least, this last view is precisely the argument that we have been advancing for quite some time. To be sure, we are witnessing a typical financial bubble. Just as clearly, it is obvious that it is fuelled by the Fed's aggressive reserve and interest rate policy. On these points we couldn't agree more. Yet on virtually everything else, we must thoroughly disagree with the readings of the monetarist group. Most importantly, we must completely debunk their views on what happens in the future.

CONSEQUENCES OF OVER-EASE

What will be the final outcome of the Fed's current permissive policy and its resulting bubble? That's the most crucial question today. The monetarists, for one, are absolutely certain that excess liquidity will eventually feed through into the real economy and cause higher consumer price inflation.

Apparently, many observers share this view. It seems so logical to think that there must be a point where the liquidity piling up in the securities markets begins shifting out of overvalued financial assets and into real economic activity, fuelling an inflationary boom. In this scenario, it's believed that bonds would suffer steep declines, reflecting rising interest rates, while stocks would benefit from improving prospects for profits.

This opinion couldn't be more wrong. Asset price bubbles invariably end in one and the same way — a bust. And when that happens, the wholesale destruction of the liquidity that's trapped in the bubble tends to depress the economy. There is no other possible alternative. We want to explain.

First, a look at the history books is instructive. Actually, this discussion about the implications of a financial bubble and the need to act against it has a famous, historical precedent. In 1928-29, member Federal Banks of the Federal Reserve System, particularly the New York branch and the Federal Reserve Board in Washington, had a heavy debate on this topic.

At the time, many people in the Fed were very alarmed about the frenzied stock market speculation that was occurring. There was even agreement that something needed to be done against it. However, they couldn't agree on the specific measures.

The Reserve Banks wanted to break the speculative stock market spiral with drastic rate increases, quickly followed by rate reductions before the higher cost of money would have time to affect regular economic activity. However, the frequent recommendations by the New York Fed to raise the discount rate from 5% to 6% for that purpose were always turned down by the Board. Instead, the Board dabbled in "moral suasion" and other futile attempts to restrain credit for "illegitimate" stock market speculators while keeping it abundant for "legitimate" trade and industrial activity.

Why did the central bankers at the time worry so much about the speculative frenzy in the stock market?

What exactly was the calamity that they were afraid of? Were they fearful that an inflationary boom would follow in the real economy? Or, did they fear that an eventual market crash would depress the economy? In short, it was the potential for a crash that they feared . . . nothing else, even despite the strong money growth.

It was obvious to them that the fantastic rise in stock and bond prices had its source in the loose monetary policy. There was bound to come a day when, for whatever reason, prices would come crashing down from their rarefied levels and negatively impact economic activity. Their prescription, therefore, was to moderate the potential impact of the inevitable crash on the economy by restraining the speculation.

How do you measure whether stock markets are overheated and vulnerable to a crash? In 1929, the crash prophets worried mainly about two things: inflated price-earnings ratios (P/E's) and the inflated credit and money growth that was largely rushing into the financial markets. In a letter to Keynes, a Fed member, Snyder, specifically pointed to the heavy bank purchases of bonds as the main culprit. He argued that these purchases forced down the long-term interest rate and gave a tremendous fillip to the stock market. Exactly that is what is happening today.

THE QUESTION OF VALUATION

Just how expensive is the stock market today? Based on price-earnings ratios, stock prices today are overvalued as never before. (See the Table on the opposite page.) Goldman Sachs recently published a paper posing the question: "Are Stock Markets Overheated?" The short answer was that in terms of historical P/E ratios, stocks appear grossly overvalued, but relative to record-low short-term interest rates most major equity markets are undervalued. As might be guessed, Goldman Sachs made the case that only the latter measure counts as relevant.

In our view, this comparison of P/E ratios with short-term interest rates is not only grossly flawed but almost fraudulent. What do short-term interest rates reflect? The availability of savings or arbitrary central bank policy? Since we are looking at capital markets, the one and only valid gauge of stock market valuations are long-term interest rates, and by that measure today, most stock markets are ridiculously overvalued.

The current bull market — indeed financial mania — in bonds and equities is global. Still, there are considerable differences in the scale of financial imbalances and excesses suggesting significantly different levels of vulnerability. Some markets, among them the U.S. stock and bond markets, are overheated and out of balance as never before . . . actually even more so than in 1929. How can that be measured?

To be sure, there are no precise yardsticks. Just recently, in reference to the U.S. financial markets, the London Economist ruminated: "*When a bubble is not a bubble*". It advanced the standard, well-known arguments of the bulls. With U.S. inflation heading towards 2%, a 30-year bond yielding 5% would not be outlandish. (Presently 30-year bond rates are a little below 6%.) Nor could the U.S. stock market be regarded as overheated, they maintained, in view of the fact that it was selling on a prospective P/E ratio of only 17 compared with Japan's 78.

IDENTIFYING A SPECULATIVE BUBBLE

Just what defines a bubble? To identify an inflated, speculative bubble, one first needs to have an idea

of what factors are operative in a country that fundamentally determines its asset price levels. Generally speaking, it is the supply of assets — both financial and real — relative to the supply of available savings that determines asset price levels.

The first big misconception of the bulls is that bond yields are tightly tied to inflation. That's an absolutely absurd assumption. Essentially, this view implies that credit demand, budget deficits and savings are irrelevant to the determination of interest rates levels.

COMPARATIVE STOCK MARKET VALUATIONS
International Price-Earnings Ratios

Country	Historical Average[1]	P/E Sept.1987[1]	P/E Present[2]
United States	11.9	15.5	23.0
United Kingdom	N/A	15.6	19.0
Germany	12.5	16.4	18.0
France	16.0	16.3	18.0
Japan	30.5	56.2	90.0+

All price-earnings multiples based on 1-year forward earnings.
[1] Source: Goldman Sachs, Historical Average 1973-1974
[2] CCM Estimates

True, U.S. growth has slowed sharply in recent years which works in favour of lower interest rates. Nonetheless, credit growth remains far in excess of available domestic savings. Currently, total credit is expanding at an annual rate of $600 billion, far outstripping a savings supply of barely $300 billion.

That's a supply/demand imbalance of truly colossal magnitude. By itself it ought to keep interest rates high. The fact that interest rates have fallen so steeply raises the question: Where is all of the money that is pouring into the stock and bond markets coming from? Not from savings. That's absolutely clear. It must therefore be originating from the source that has generated all other bubbles — monetary inflation fuelled by excessive reserve injections and artificially low interest rates. It is this combination of factors that marks the current situation in financial markets as a true speculative bubble.

CHOOSING THE LESSER EVIL

What would have happened if the Fed had not pursued such an extremely loose monetary policy during the past few years? Undoubtedly, interest rates would have stayed considerably higher. This would have curbed the financial boom but it would also have hindered the economic recovery.

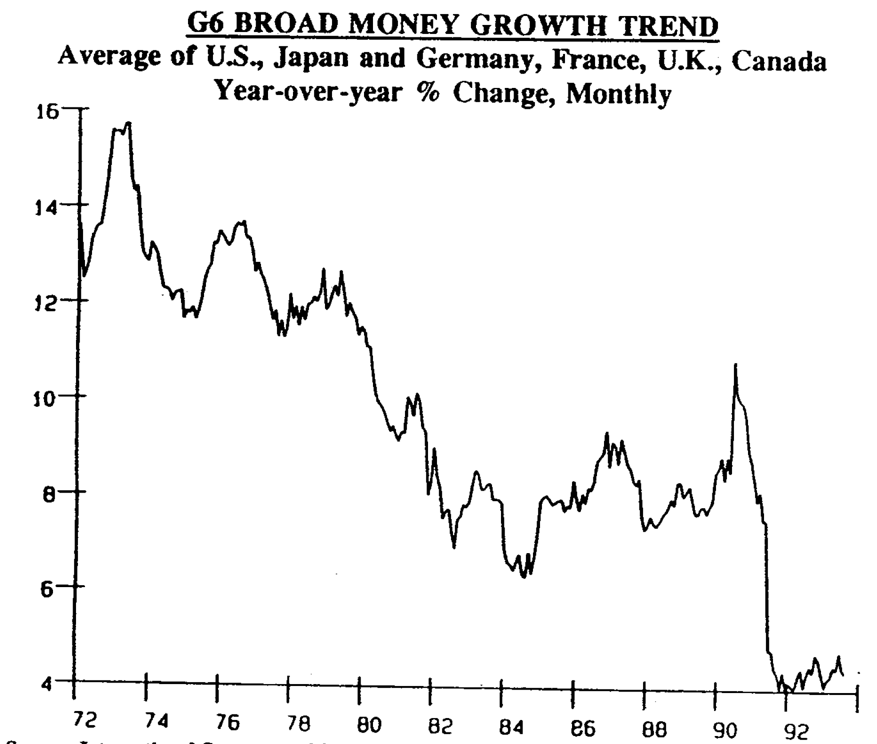
Does this mean that it was a good monetary policy? To us, this question brings to mind the 1928-29 experience as an example. At the time, no doubt, the Fed's easing which chiefly served to inflate the stock market also prolonged the boom in the economy. Yet in 1929, this policy resulted in the stock market crash and the onset of the Great Depression. What seemed to be a good policy over the short run proved to be a disastrous one over the long-run.

THE GREAT MONEY PARADOX

As the Economist correctly mentions, speculative bubbles have always occurred in economies experiencing exploding loan and money growth. This was true, for example, of the U.S. mania in the 1920s and also of all the bubbles that developed in the late 1980s in Japan, Britain and elsewhere. This time, however, credit and broad money growth are extremely weak. How can there be a bubble under these conditions?

Nevertheless, according to the consensus view, the present stock and bond market booms are essentially thought to be "liquidity driven". Traditionally, this term refers to a situation where money grows faster than nominal GDP (Gross Domestic Product). In this vein, the monetarists in their recent report complain that the U.S. economy is "*awash with liquidity,*" pointing out that 11% growth in the monetary base over the last year is twice the growth of nominal GDP.

The great paradox is that the true liquidity trend is exactly the opposite. Measured by broad money, most industrial countries are experiencing the lowest liquidity growth of the whole postwar period. To have this coincide with extremely bullish financial markets is admittedly unprecedented in history. The chart below shows the average broad money growth trend for the three major countries, the United States, Japan and Germany.



Source: International Strategy and Investment

While this extremely contradictory behaviour of broad money and markets is a new global phenomenon, the U.S. pattern is of particular interest for two reasons: firstly, it's the most extreme of all the cases; and secondly, the key role that Wall Street plays in the scenario.

Consider this: Since October 1990 when this bull-run in the markets first started, U.S. M2 and M3 have increased by a mere total of 5.9% and 1.3%, respectively. This money growth compares with cumulative nominal GDP growth over this period of 12.5%. In other words, there is a persistent, progressive shortfall of liquidity growth relative to GDP growth which has no parallel in the whole postwar period. We emphasize this point because it flies in the face of the general perception that the booming markets reflect excess liquidity. Yet, despite that, financial markets rise ever higher.

THE WELLSPRING OF BUBBLE ECONOMICS

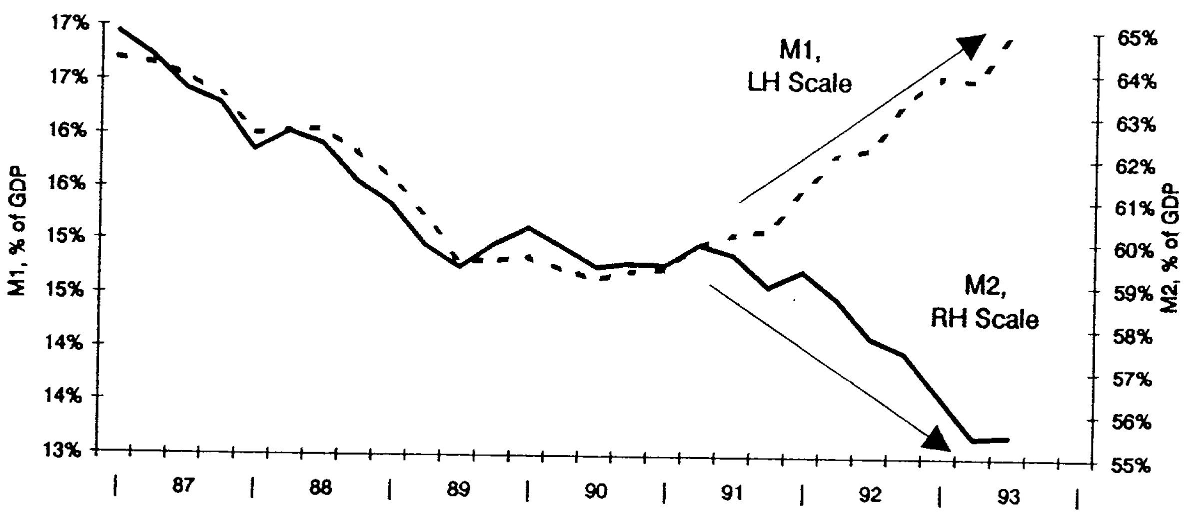
If it's not broad money growth that is buoying these markets, what else could it be? The short answer — interest rates. The crucial lever for the U.S. markets are artificially-low, short-term interest rates — the 3% Fed funds rate, imposed and rigidly pegged by the Fed, and the associated deposit rates of 2.75% and less. By slashing short-term interest rates to this abysmally low level and given the poor investment opportunities in the sluggish economy, the Fed literally chases existing and new money into stocks and

bonds. The critical point to realize is that these rates are artificially low and grossly out of line with long-term rates and the underlying credit market conditions.

The Fed funds rate plays a most obvious and key role in the U.S. stock market. Faced with abysmally low interest yields, savers and investors stampede out of bank deposits into stocks hoping to secure higher returns. With inflows into equity mutual funds of around $10 billion a month, it is obvious that the obscenely low short-term rates are the prime mover behind the stock market.

MONEY BUBBLE: U.S. M1 VERSUS M2

M1 and M2 as a % of Gross Domestic Product, Monthly



Source: Federal Reserve Bank of New York
Format: CCM

From a monetary point of view, it is significant that this "asset switching" — moving from deposits to the longer-dated assets of stocks and bonds — involves no money creation. Neither does it reduce the money supply as many people think. All that happens is that money circulates between the buyers and sellers of stocks and bonds. The money never leaves M2. One persons deposit simply is transferred to another. What happens is that demand deposits (chequing accounts) rise relative to savings and time deposits as the transactional demand for stock and bond purchases rises. The graph above shows this to be the current case. M1 components of money have risen sharply as a percentage of GDP whereas M2 has declined. What this proves is that M1 is busy in the financial markets but not in the real economy.

What about the Fed's role in the bond market? There, too, the fixed federal-funds rate is the pivot point. What's different here are the players and the mechanism of speculation. The crucial and operative factor is that the Fed has set the funds rate far below the level of longer-term rates. By doing so it has created a yield curve of unprecedented steepness (long-term rates being much higher than short-term rates) which begs for extensive exploitation by banks, brokers and other institutions with access to low money market rates. Given the easy, lucrative profits that this "gravy train" offers, these players have joined in with reckless abandon. During the last two-and-a-half years, banks alone bought more than $260 billion in bonds while brokers bought about $100 billion. That's more than their entire purchases during the entire 1980 decade.

THE MESSAGE OF SOARING M1

In reality, something more than just abnormally low interest rates is required to keep a speculative frenzy going in financial markets. Where the snag comes in is that a rampant speculative mania inflates the demand for transaction money (M1) . . . in other words, money in chequing accounts. At the same time, the bank's bond purchases have the effect of increasing money supply by an equal amount. As we want to explain, that can't happen unless the Fed allows it.

According to textbook economic models, money supply is solely related to economic activity as measured by GDP. To believe that can be a fatal error since a large part of the money supply is always employed in transactions that have no connection with GDP. GDP, to recall, only concerns itself with the current production of goods and services. Transactions outside of this, such as trading in stocks, bonds, derivatives, or real estate are outside of GDP. If these transactions grow out of proportion to economic activity, as is presently the case, the money numbers go awry in relation to GDP.

In fact, that is the explanation for the puzzling inflation of U.S. M1. Most obviously, it is linked to inflated flows of funds into the financial markets. Normally, such an overexpansion of M1 would be curbed by the reserve mechanism. All sight deposits (demand deposits) are subject to a minimum reserve requirement of 10%. But by flooding the banks with reserves, the Fed deliberately overrides this braking effect. What's more, by wantonly pumping excess reserves into the banking system, the Fed virtually coerces the banks into playing the yield curve as a substitute for bank loans.

Distilling all this down to a brief summary, the Fed's strategy can be summed up as follows: By imposing abnormally low short-term interest rates, it has unleashed a headlong flight into stocks and bonds and through its abundant reserve injections it has accommodated and given free rein to a speculative boom. The message of soaring M1 is frenzied speculation.

THE SICK SISTER TO FINANCIAL MARKETS: THE ECONOMY

It is easy to see that the U.S. financial boom is Fed-generated. The more difficult question is why such ultra-low interest rates and securities inflation have not rubbed off on the economy. The monetarists and many others are convinced that this is sure to happen eventually. We are convinced that it won't.

Slowly, too slowly, it is being realized that the cause of the past recession and the subsequent sluggish recovery in the United States and elsewhere is largely of a structural, not cyclical, origin. Given this beginning recognition, you would expect some probing and research as to the specific structural maladjustments and their implications for economic recovery and growth.

Unfortunately, what we see is a torrent of mindless number-crunching. Forecasters with their quantitative and econometric models continue to spew out forecasts based on past patterns and relationships that no longer hold. Far from being discouraged and seriously concerned, the persistent growth disappointments seem to enhance the prevailing complacency instead. Everybody finds solace in the idea that a poor recovery is good because it suppresses inflation and therefore has beneficial valuation effects for financial markets. Connected with this idea is a naive, fallacious belief that rising financial markets and low inflation are symbols of economic health and sustained future economic growth. Taking this ridiculous notion further, one wonders why an economic depression wouldn't be even more bullish. Inflation would happily be even lower in that case.

NO NEW GOLDEN AGE

Numerous pundits are conjuring up happy memories of the "golden" 1950-60s, when strong U.S. economic growth coincided with 2% inflation and low long-term interest rates of 4%. Expecting a new era of low inflation — much like the 1960s — leading Wall Street economists validate their forecasts of long-term interest rates falling below 5% and rising stock markets.

We would say that anybody drawing a parallel with the 1960s reveals that they are a charlatan in economics. A more thorough comparison of the differences in the underlying conditions of the two periods, in fact, actually leads to an understanding of just how deep-seated the U.S. economic and financial malaise is today.

During the 1950-60s, U.S. annual real GDP growth averaged 3.9%. This was achieved through the combination of a 1.6% growth rate in employment and 2.3% in annual productivity gains. High growth, low inflation and low interest rates were the result of high savings and investment. Net national savings and investment ratios amounted to 6-7% of GDP in the 1950s and 8-10% in the 1960s. Together with a chronic trade surplus, all these factors were evidence of the structural condition that domestic savings persistently exceeded domestic borrowing.

Knowing these figures, the assertion that the U.S. economy is returning to the 1950-60 "norm" couldn't be more ridiculous. Today's environment is diametrically opposite. Net savings and investments have plummeted as a share of net national product (GDP less depreciation) to almost zero. Credit demand and savings supply, as described earlier, are extremely out of kilter. What's keeping inflation low today is a depressed economy and an income/profit squeeze, not high investment and rapid productivity growth. Interest rates, to the contrary, are kept low by a rampant monetary inflation.

In the 1950-60s, low U.S. inflation and interest rates reflected a healthy economy with high capital formation (investment). Today, low inflation and interest rates are a function of a sick and weak economy. Bearing this in mind, think of this: In the healthier 1950-60s, U.S. stocks traded at around 17 times trailing earnings. Today, the S&P 500 is valued at 23.86 times most recent earnings and the S&P industrials at 27.8 times . . . hardly a bargain.

THE STRUCTURAL CRISIS

The above comparison of economic conditions of the 1950-60s and the 1990s shows why the U.S. economy today is in the grips of a structural crisis . . . something very different than the more normal bursts of recovery following short-run cyclical recessions. Inflated government and consumer borrowing in the 1980s inflated U.S. consumer demand, and in its wake, caused the overexpansion of consumer service industries. This effect had its counterpart in the relative shrinkage of investment spending and capital goods industries. As a result, the U.S. economy's whole demand and output structure became severely lopsided toward consumption.

The trouble is that such debt excesses and the associated overconsumption cannot be sustained forever. Inevitably, there comes a day of reckoning when for some reason or another the over-inflated borrowing slows. That has happened. As credit-financed consumer spending sharply declined after 1988, it correspondingly depressed production and incomes in the affected industries.

So, the earlier structural crisis in the capital goods industries — caused by overconsumption — is ultimately followed by a structural crisis triggered in the consumer industries by the termination of the borrowing binge. In the end, the whole economy shrinks. An investment crisis translates into a profit crisis, and vice versa. As a matter of fact, this sequence perfectly fits Frederich Hayek's explanation of the Great Depression. The major distortions and maladjustments in the economy's whole demand and output structure were the deeper cause of the decline. The readjustment — or healing stage so to speak — takes many years and in the process keeps both investment and consumption in a depressed state.

It's instructive to compare this "structural" crisis with the standard model of a "cyclical" recession. The latter recessions were generally and mainly a function of the liquidation of excess inventories. This, fundamentally, is a short-term phenomenon. After about a year, once inventory adjustments have been completed, economies promptly returned to "trend growth". The Great Depression was the first exception to this pattern in this century, involving prolonged falls in fixed investment and consumption.

This time, just as in the 1930s, inventory adjustments are playing a minor role. Everywhere countries are struggling with major distortions in the supply and demand structures of their economies caused by the rampant credit inflations of the 1980s. Yet, there are considerable differences in the extent and pattern of the resulting distortions between countries. Most — above all the Anglo-Saxon countries — have boosted their consumption to unsustainable levels, in the process ravaging capital formation and trade balances in the model of the United States.

The most extreme and opposite kind of distortion to the type that occurred in the U.S. is seen in Japan. There, the credit inflation of the 1980s allowed businesses to massively over-build and over-invest. Accordingly, the Japanese recession is now centred in an investment collapse, which adversely impacts overall production, incomes and consumer spending.

The German case is very different again. Since the country had no credit inflation, it avoided the great structural distortions that afflicted most other countries. On balance, there was a sizable and healthy shift of resources away from consumer and government spending towards investment spending and an export surplus.

FROM BUBBLE TO CRASH

Why are we so sure that a financial bubble is a prelude to a crash and not a booming economy? In short, bubbles — inflated asset prices — create illiquidity, not excess liquidity as many people falsely believe. What others regard as overliquidity, we regard as a liquidity trap.

The truth is that more and more investors are abandoning liquid deposits in favour of illiquid bonds and stocks while the banks and brokers, with their reckless yield-curve playing, are exposing themselves to massive interest-rate risk. That's exactly how the S&L's ruined themselves. Any small rise in short- or long-term rates threatens to burst the bubble. Comparing the extremely sluggish broad money growth with the soaring market capitalization and the growing nominal GDP, the unpalatable truth is that the U.S. economy's liquidity base is at its lowest level in decades. What we see is the Fed driving the system into illiquidity.

For the time being, this buying binge is boosting stock and bond prices and is creating the illusion of abundant liquidity. But large-scale selling would in turn severely depress bond and stock prices. Liquid

markets and assets would suddenly become illiquid. The key thing to realize is that it's technically impossible to shift liquidity from the markets into the real economy because for every seller there always must be a buyer. The money is definitely trapped in the markets. Unavoidably, what happens when too many run for the exit at the same time is a crash. That's what we call a liquidity trap.

THE MESSAGE OF SLUGGISH M2

For reasons already explained, we think the U.S. economy is stuck with a long-lasting structural crisis which inhibits its return to normal growth. What has to happen to signal that the impediments inherent in this crisis are being overcome? The strategic factors to watch for are a pick-up in (1) private credit growth, (2) broad money, (3) business investment, (4) building, and (5) business profits. Strong economic growth heavily depends on these five aggregates.

As for the abysmally low credit and broad money growth, there still is no meaningful pick-up. An obvious cause behind this weakness is extremely sluggish investment — both business spending and residential building. Credit plays a heavy role in these spending categories. As we have often emphasized, surging investment spending is the motor of every cyclical recovery.

To date, it is true that investment spending has recovered faster than consumption. Taking note of this, some are exuberantly proclaiming the beginning of a new era in which the productive side of the economy will grow much faster than the demand side. What they fail to realize is that overproportionate investment growth is the normal pattern of every cyclical recovery, and that by that measure, this cyclical investment recovery is unusually weak. The message of sluggish M2 is weak investment and credit.

It's the quest for profit that drives business activity. Looking at the U.S. economy over the past twenty years, there is an ominous parallel between a secular decline in capital spending and profits, both being intertwined in a vicious downward circle. Despite gains in operating profits and investment outlays during the recovery, profitability remains profoundly weak by postwar standards. Nevertheless, there is a complacent view that business profits will thrive and thereby support stock prices. Even in face of economic weakness, it's believed that profits can rebound because of great efficiency gains achieved through "restructuring" and "downsizing". It's another big deception.

If a few firms retrench, it may be to their advantage. But if many firms attempt to do so, it spreads more weakness. At best, it's a zero sum game. More probably, it degenerates into a self-defeating and vicious cycle of contraction. If it were combined with strong new investment, it would be seen as a sound development. But with weak new investment, it's disastrous for long-term growth. The one and only thing that can raise profits on a sustained basis is new investment due to its highly leveraged effect on the economy.

Temporarily, business profits have been helped considerably by sharp declines in interest rates and a soaring budget deficit. Now that both influences have exhausted themselves, profit growth has slowed dramatically. The decline in the budget deficit and the rise in the trade deficit foreshadow serious profit declines early next year.

CONCLUSIONS

The bull markets in stocks and bonds may well continue for as long as a sluggish economic environment

excludes the possibility of any monetary tightening.

To varying degrees, there is speculation in all markets. What we have tried to show in this letter is why the U.S. markets are extremely overheated and the most vulnerable.

As always, there are plenty of new theories that postulate that a completely new era is being witnessed in which the valuation measures of the past are no longer valid. Such assertions have never proved to be true before.

Eventually, a crash is inevitable. The problem is that there is no reliable way of predicting its trigger and timing. In the meantime, it's important to be aware of the anomalies and the huge risks that exist. The most obvious threat to the stock market are profit disappointments.

The U.S. dollar should continue to fall further. The decline can be expected to accelerate when disappointment over the economy spreads and deepens.

Investors should defend themselves against the fall-out of the bubble economies and the financial bubbles — particularly the U.S. stock and bond markets and probably global stock markets in general.

The main priorities are to preserve liquidity and capital. The best way to achieve those objectives is to focus on domestic short-term money securities and hard-currency bonds — the bonds of Germany, Netherlands, Switzerland and Austria.

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